CORPORATE PENSION FUND INVESTMENT PROGRAMS: THEIR POLICIES, OBJECTIVES AND PERFORMANCE

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A Thesis Submitted to the School of Government and Business Administration of The George Washington University in Partial Fulfillment of the Requirements for the Degree of Master of Business Administration

April 1972

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CHAPTER I

INTRODUCTION

BACKGROUND

Corporate pension funds are the largest and fastest growing pool of private capital in the United States today. The total assets of these pension funds amount to over $125 billion, which exceeds the combined 1970 assets of General Motors, Standard Oil (N. J.), Ford, General Electric, Texaco, IBM, Chrysler, Mobil Oil, ITT, Gulf, and U. S. Steel.[1] Even with this vast pool of capital in existence, there is considerable doubt in the minds of financial, economic, and government authorities as to whether or not these funds are receiving the necessary attention, time, and management that is commensurate with the great size and amounts of monies involved. Historically, corporate pension fund managers have been seemingly unconcerned in their handling of these funds and extremely conservative in their use; being content mainly with allocating the funds into investments that require no involved management procedures or undue expense, promise of a high degree of safety of capital, and only a nominal rate of return.

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[1]Charles D. Ellis, "Danger Ahead For Pension Funds," Harvard Business Review, May-June 1971, 50-51.

Table 1 shows the tremendous increases of both total assets of private pension plans and total benefits paid under these plans from 1950 to 1969. The recent trend of continually increasing pension benefits, plus the fact that close to one half of those employed in the nation's industry are covered by pension plans as compared to only 25 per cent twenty years ago, is forcing corporate financial managers to make the administration of a firm's pension fund a major enterprise within the corporate structure.[1] In addition to the increasing assets, benefits, and wider coverage of pension funds, other factors that have contributed to the increased attention to pension fund administration are the effects of almost uncontrollable inflation, the institutionalization of the financial markets, and the ever increasing concern for public welfare by government officials.

PURPOSE OF THE STUDY

The above discussion leads to the primary purposes of this study; an investigation of the policies and objectives of pension fund managers, what particular problems face these managers, and, most important of all, a determination of what degree the funds have been and will be successful in coping with the discussed problems and increased pension costs in order to fulfill their primary objective of providing sufficient retirement benefits for beneficiaries.

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[1]Julian Gumperz, "Pension Funds in an Age of Discontinuity," Financial Analysts Journal, November-December 1970, 21.

TABLE I

TOTAL ASSETS OF AND BENEFITS PAID UNDER MAJOR PRIVATE PENSION PROGRAMS IN THE UNITED STATES, 1950-1969
($Million)

Year	Total Assets	Total Benefits Paid
1950	12,100	370
1960	51,950	1,750
1961	57,750	1,960
1962	63,525	2,250
1963	69,900	2,460
1964	77,150	2,760
1965	85,425	3,180
1966	93,925	3,680
1967	103,800	4,150
1968	115,475	4,670
1969	126,200	5,650

Source: Julian Gumperz, "Pension Funds in an Age of Discontinuity," Financial Analysts Journal, November-December, 1970.

The secondary objectives of the study are to give a brief history of pension funds and what their purposes are, to discuss how pension fund assets are invested and what investment performance has been, to describe the influence that employees and labor unions have on policy decisions of corporate management, and finally, to look ahead into the future and to project the expected future role of the federal government in private pension matters.

UTILITY OF THE STUDY

Why the big fuss over pension fund practices recently, and why is the government getting more involved and concerned with the administration of these funds? Pension assets and funding are extremely important to this country, as well as to business and employees. The obvious and desirable goal of the government is to ensure that all elderly citizens are able to live a comfortable, welfare-free life after retirement, with private pension and government social security benefits providing all the funds required to sustain an acceptable standard of living. Besides the public welfare aspect, private pension plans have significance, as far as the government is concerned, in that they supplement the basic public system and add values to industrial life not provided by the Social Security system.

The steady increases in average wage levels and the trend toward increasing pension costs will place extremely heavy demands upon pension fund assets over the years ahead. Therefore, besides having to be concerned with how the pension plans are funded, financial managers are also vitally concerned with obtaining maximum investment performance and rates of return from the pension fund portfolio of investments. It is an established fact that the most crucial problem faced by pension plans is the achievement and maintenance of rates of return of asset accumulation that can match the build-up of liabilities the funds will have to meet in the 1970's and beyond.[1] Additionally, certain government and labor union pressures have been exerted on corporations that will eventually mean that pension plans will be required to not only raise benefit payments for persons long retired beyond all proportion to their earnings while working, but also to provide benefits to employees who never participated in a pension plan.

Despite all the above factors which will increase pension costs considerably in the coming years, a recent survey of pension fund management policies and practices in large corporations found that a substantial majority of the senior executives responsible for pension funds spend only a small portion of their time on pension policy and strategy, and make no long-term forecasts of either future benefits or the future contribution that their companies will have to pay into their funds.[2]

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[1]Ibid., 20.

[2]Ellis, "Danger Ahead," 50-51.

The results of this survey point up the fact that if there is any single critical need in the pension and profit sharing business it is for competent, conscientious, and responsible money management.[1]

Faced with these increased demands, companies have essentially two ways of obtaining the funds required for future benefits. They can either contribute greater amounts out of corporate earnings, or attempt to increase the asset values by more aggressive investments in common stocks and bonds. Most companies have chosen to do the latter, and therefore have inadvertently been drawn into the performance race that has been the by-word of many mutual funds for so many years. As long as the economy and the stock market are performing well, the pension funds are not under any particular pressures, internally or externally. However, the ravages of the bear market of 1969 and 1970 have caused a substantial loss in market value of the assets of thousands of pension funds. Under these conditions, corporate operations are affected by the erosion of pension fund value in two separate ways: (1) in the annual cash contributions to the fund that will be required, and (2) in the effect on earnings per share of the accrual of pension costs.[2] In any year pension costs are a

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[1]Partners at Neuberger and Berman, Investment Firm, interview on "Pension Portfolio Management," Pension and Welfare News, February, 1971, 45.

[2]Darrell J. Croot, "Coping With the Decline of Asset Values in Pension Funds," Financial Executive, November, 1970, 20.

major expense for a company, but what is devastating to a company is to be forced to pay more into pension funds during poor economic conditions and bear markets, just at the time when corporate profits are usually decreasing.

Since companies do not have to reveal investment performance figures, there is no real way of knowing how well individual company funds have weathered the bear markets and to what extent it has affected corporate operations. Additionally, comparing rates of return for different companies is equally difficult because objectives, responsibilities, and consequences of investment failure are different for each corporation. What might be a satisfactory return for one program may be highly unsatisfactory for another. Nevertheless, maximum portfolio performance, but always within the framework of the constraints upon a particular fund, must be the aim of all fund managers, whether or not the results are published.

The basic questions that are being frequently asked of private pension funds are: Is it probable that the sum of contributions to pension funds, plus return on assets, will be adequate to meet the liabilities that pension funds will be incurring over the next decade or so? Or is it more likely that, at a certain time not too far distant, inpayments to the system will begin to lag behind current contractual obligations for outpayments from it? The grim possibility that continually looms in the background is that even though a pension fund's assets may be growing, the fund itself is becoming more and

more insolvent actuarially, and the reason is that full measure of its future outgo may take many years to fully develop.[1]

SCOPE AND ORGANIZATION

This thesis will mainly attempt to discuss present policies, objectives, and practices connected with the administration and management of corporate pension funds. Quantifying rates of return and investment performance has already been deemed a very difficult task, if not impossible; however, some measurements will be presented that are pieced together from various sources.

This introductory chapter discusses the problems and some causes of the problems facing pension fund managers. It establishes the need for more attention to corporate pension fund administration and management.

Chapter II will briefly describe the history, purpose and types of pension plans available, and how they are normally funded.

Chapter III will discuss general policies and objectives of private pension fund managers, and just what implications and affects are accrued from employee and labor union relations.

Chapter IV will concentrate on pension fund investment programs. The general content of pension fund portfolios, how these portfolios have performed, and the impact of pension costs of corporate earnings will all be discussed.

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[1]William F. Marples, "Actuarial Aspects of Pension Security," in Gumperz, "Pension Funds," 21-22.

Chapter V elaborates on the increasing government concern for pension funds, what reforms are proposed, and what the future holds for the private pension business in the United States.

Chapter VI contains the summary and author's conclusions as a result of this study.

RESEARCH METHODS UTILIZED

By far the greatest amount of material for this study has been drawn from periodicals. Very few current books have been published on the problems facing pension fund management, which is understandable because of the very contemporary nature of the problems involved. Libraries used were the Naval Supply Systems Command, George Washington University, U. S. Department of Labor, and Fairfax County Public Library. Also utilized was the Public Documents Section of the Securities and Exchange Commission.

Interviews and correspondence with trustees, actuaries, and pension fund managers were attempted, but, due to the highly confidential nature of the subject matter (as far as the company was concerned), very little worthwhile information was gathered from these sources.

CHAPTER II

GENERAL BACKGROUND OF PENSION FUNDS

DEFINITIONS

Before going further into the discussion of corporate pension plans, it is well to describe what a pension fund actually is, and how it differs from a similar employee incentive plan, the "profit sharing" plan. There are many definitions of pension fund, but one that would be all-encompassing is the following:

A pension plan is "an orderly, systematic, method by which an employer can provide for the payment of definitely determinable benefits to his employees for a definite period of years, usually for life, after retirement." The company makes a long-term commitment to fund the program adequately so that the monies will be available when needed. Some annual flexibility in timing pension contributions to meet these long range goals can be worked into the program.[1] A pension fund is basically a company's pledge to pay certain benefits through a long period of time in the future.

On the other hand, a deferred "profit-sharing" plan is basically "an incentive approach to employee security." It is

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[1] Bert Metzger, Investment Practices, Performance and Management of Profit Sharing Trust Funds, (Evanston, Illinois, Profit Sharing Research Foundation, 1969), p. vii.

a plan established by an employer to provide for the direct and automatic participation by employees in corporate profits - with payment of benefits at retirement, death, disability, severance, and possibly during employment. Deferred profit sharing strives to develop a closer mutuality of interest between a company and its employees, and it gives employees a chance to earn added security through their own extra cooperative, productive efforts.[1]

The following discussions will center around a funded, benefit type of pension plan, which is the usual arrangement for corporate plans. Although there are multi-employer plans and many municipal plans, the corporate plan is the primary subject of investigation in this paper. scope

HISTORY AND PURPOSE OF PENSION PLANS

The development of industrial pension plans did not occur overnight, or even in a matter of a decade. It appears that the first plan was established in 1875 by the American Express Company, followed closely by the railroads, which adopted pensions as a way of retiring trainmen and enginemen who were too old to continue their hazardous jobs.[2] By the early part of the 20th century, some unions, and state and local governments began financing their own plans, followed

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[1] Ibid.

[2] Gilbert Burck, "That Ever Expanding Pension Balloon," Fortune, October 1971, 103.

closely in 1935 by the enactment of the Social Security Act by Congress. This act was the first step toward providing nearly all employees with at least some retirement funds, although it required the employee to contribute sums out of his wages.

Many factors present in the decade 1940-1950 greatly accelerated the growth of pension plans, with World War II being a definite influence. There was a very strong interest in attracting and retaining employees during the war, and when wage and salary controls were imposed, corporations used wartime profits to finance pension plans in lieu of granting wage increases. The high tax rates on personal income and corporate profits added further impetus to the idea of income deferral in the form of pension benefits.

Then in 1948, the National Labor Relations Board's decision in the Inland Steel controversy virtually sealed the case for pension plans by deciding that retirement programs were a proper subject for collective bargaining and enabled labor unions to have a large say in the drafting of plans.[1] At this point in time, pension plans were recognized as serving a useful and necessary function in our society, but there were still only a relatively few workers covered by the plans. Social security, although already in effect for some years, provided only a minimal income. This fact, plus the very existence of the unhappy position of many older

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[1]Metzger, Investment Practices, p. 2.

people, no longer able to earn a living wage, aroused the conscience of society.

One prime example of the nation's concern for this problem was the statement of the Steel Industry Board, appointed by the President in 1949, which stated:

"Social insurance and pensions should be considered a part of the normal business costs to take care of temporary and permanent depreciation in the human "machine" in much the same way as provision is made for the depreciation and insurance of plant and machinery. This obligation should be among the first charges on revenues."[1]

Having been stimulated by both government and society, there developed in business a growth of a statesmanlike attitude which, in conjunction with prosperity, stipulated that pension benefits were both necessary and good for the economy. Having been deemed good for the economy, it therefore followed that they were good also for business.

With this support from society, business, and government, the private pension business expanded phenomenally. As the chart on page 14 shows, the number of people covered by private plans rose from 4,100,000 in 1940 to 31 million in 1970, and the assets of the funds increased from $2.4 billion to about $136 billion. By 1980, if the funds keep growing at present rates, their assets will amount to more than $250 billion.[2]

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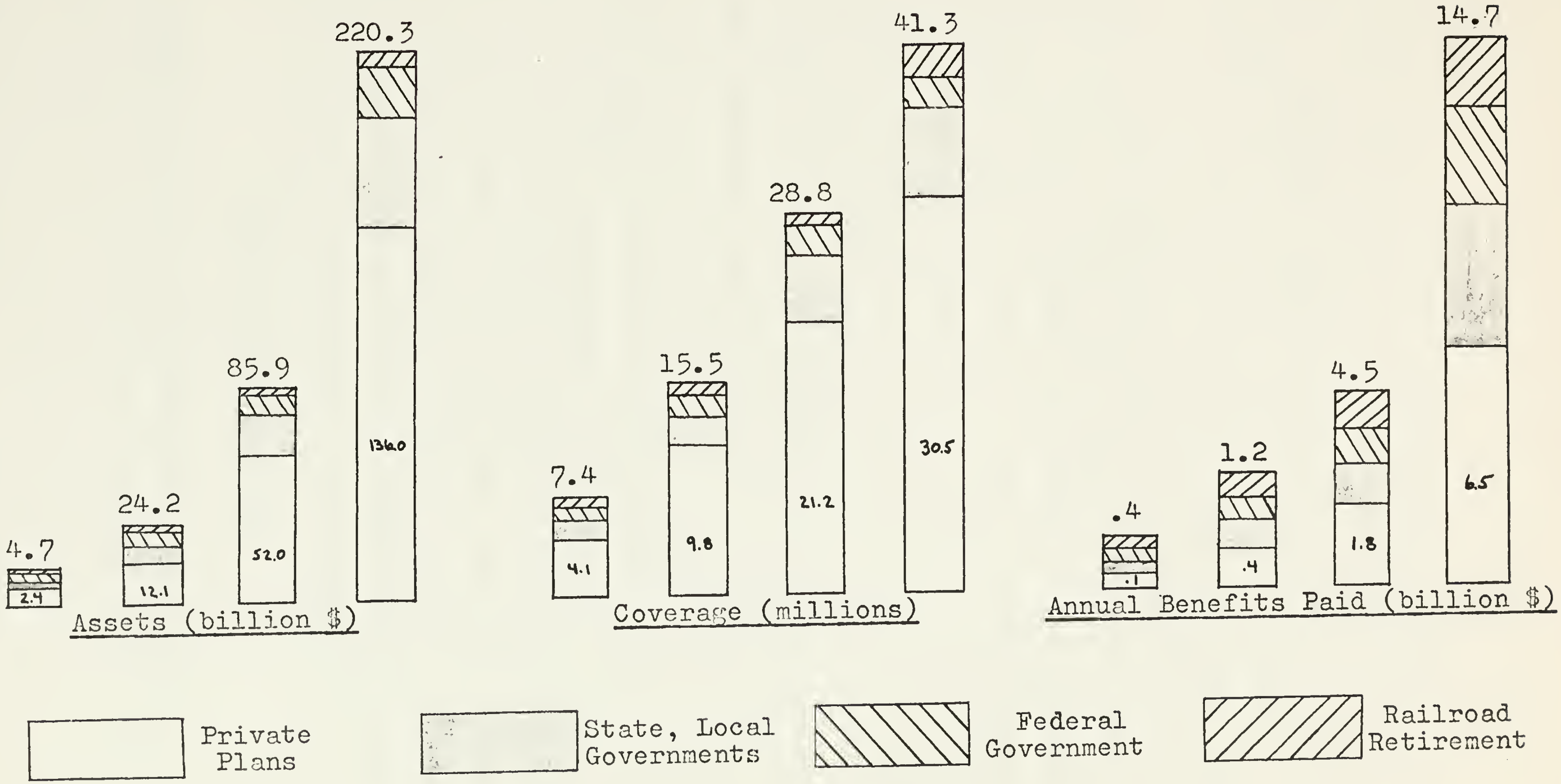
[1] Ibid.

[2] Burck, "That Ever Expanding Pension Balloon," 101-103.

Chart I

Assets, Coverage, and Annual Benefits Paid of Pension Plans

1940-1970



Source: Fortune, October, 1971, p. 101.

The purpose of private pension plans, as well as all other pension plans, has already been inferred in the above discussion. Basically, pension plans provide income to those who have worked and who retire from choice or necessity. Social security is providing ever increasing benefits to all eligible recipients in this country, but with inflation and the cost of living continually rising, these benefits serve to satisfy only a little more than the minimum requirements. Private pension plans supplement these benefits to enable a retired person to live at a standard of living that is closer to the standard that he has enjoyed through his productive, working years. Having these people remain self supporting after wages and salaries cease to exist for them is extremely important to not only the individuals themselves, but to the whole nation as well. Decreased welfare costs are an immediate benefit to the government and society benefits because retired employees have a certain degree of financial independence and will remain active purchasers of goods and services instead of becoming dependent upon the wage earners or the community. The goal of attempting to keep all citizens, working or unable to work, in a self-supporting capacity is definitely a highly desirable goal, extremely healthy for citizens and the country alike.

TYPES OF PENSION PLANS

Pension plans are not restricted to corporations alone; employees of partnerships and sole proprietorships may also be

provided for. Additionally, recent legislation introduced by the President would authorize all working individuals to take advantage of specified tax benefits by setting up a pension plan for themselves. This will be elaborated on later.

A qualified pension plan is one that meets the requirements of the Internal Revenue Code. All qualified pension plans are the same in most respects in that they must provide benefits to employees in general, can include persons who work outside the United States, have no size restrictions, and are administered by a pension trust. The trust holds all the funds and represents the beneficiaries, but carries out the provisions of the employer's plan.[1]

Although most plans are similar in the above aspects, there are other slight differences among the plans that are worthy of description.

Multiple Plan. A multiple plan is a pension system with separate plans for different groups of employees. One plan may cover persons on salary; another plan may provide for workers of a particular union; and yet another plan may provide for corporate executives. However, all the plans are phases of a single system to provide benefits for employees.[2]

Insured or Non-insured Plan. An insured plan is one in which the benefits are insured, completely or in part, by

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[1]Robert S. Holzman, Guide to Pension and Profit Sharing Plans, (Farnsworth Publishing Company, 1969), pp. 3-6.

[2]Ibid., p. 7.

an insurance company. On the other hand, the plan may be uninsured, in which case the employer may set up a self-insured or self-administered plan under which trustees or a pension committee are designated to manage the plan and its benefits. The trustee as fiduciary would administer the fund and handle the investments.[1]

Funded Pension Plan. A funded pension plan is one providing for the systematic accumulation of the funds required to take care of the promised pensions. There are many alternative methods of funding a pension plan, most of which will be covered later in this chapter.

Annuity Plan. Sometimes the employer may contract with an insurance company to purchase annuities for his covered employees. The employees receive certificates outlining their coverage and benefits. Under this arrangement, the annuity plan refers to a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust. The annuities may be purchased for each individual employee or for a group of employees.[2]

Money Purchase Plan. These plans specify the employer contributions for each period of service of each employee, and the benefit credits are determined as the amounts which such contributions are sufficient to provide. Any refunds are used to increase the benefits for the employees.[3]

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[1] *Ibid.*, p. 8.

[2] *Ibid.*, p. 10.

[3] *Ibid.*, p. 12.

Deposit Administration Plan. This plan is one in which the benefits are funded by payments to a deposit account held by an insurer who credits interest and withdraws the amounts required for the purchase of stipulated annuities for individual employees. The insurer in this case usually guarantees against loss of principal from unfavorable investments.[1]

Keogh Plan. Although not specifically a corporate pension plan, it is well to define this plan. Under this plan, self-employed persons are allowed to set aside for themselves and their full time employees 10 per cent of their earned income up to $2500 annually in a "qualified" pension fund of their own choice without paying income taxes on it.[2] A "qualified" fund in this case refers to any trust, bank, mutual fund, or other institution that meets government requirements.

New legislation introduced by President Nixon, hopefully to be approved by the Congress, would allow any individual worker, self-employed or not, to set aside $1500 or 20 per cent of his annual wage, whichever is the least, without having to pay income taxes on it. This plan would essentially give the opportunity for all the nation's workers to take advantage of tax benefits by setting aside funds for their own pension plan. Heretofore, only those who worked for companies with pension plans and the self-employed were

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[1] Ibid., p. 12.

[2] United Business Service, "Pension Plan Tax Equality Still Far Off," August 2, 1971, p. 304.

able to provide pension benefits for themselves and their workers. A worker who did not fall into one of these categories would have only Social Security benefits available upon retirement.

METHODS OF FUNDING PENSION PLANS

Before a company can decide on the best method of providing funds for its pension plan, it must determine what the plan is going to cost. To get into a detailed cost analysis of pension benefits, using mortality tables, interest schedules, expected retirement ages in the future, and expected benefit increases, is beyond the scope of this investigation. Briefly however, the cost of a pension plan depends basically upon (a) the employer's tax bracket, (b) the ultimate benefits desired for the employees, (c) whether or not the plan will qualify under the Internal Revenue Code so that a full tax deduction may be taken, (d) whether employees contribute, (e) the extent to which past service will be recognized, and, (f) how many years will elapse for accumulation of funds before benefits are paid. Critical to the cost estimation of any pension plan is the extent to which investment performance and rates of return on investment are included. The higher the assumed rate of return on investments, the less money needed to finance the fund up to its required level.

Funding is the accumulation of assets for payment of future benefits. It is imperative that management have some idea of what its objectives are in order to make sensible and

logical decisions concerning the funding of its pension program. In order to do this, the essential ingredient must be information, and this information must come from different sources. The sources of information normally available to a company, and the inputs provided by each source can be broken down into three categories as follows:

> <u>Investment managers</u> provide
> 1. Return over a specified period from highly marketable fixed income securities held in the primary reserve portion of the fund.
> 2. Cash and non-cash returns for each of the types of possible investment: common stocks, convertible bonds, mortgages, leases, real estate developments, etc.
>
> <u>Wage and Salary administrators</u> provide
> 1. Estimates for each of the next several years of changes in wage and salary levels, in the number and pay-grade mix of employees, in the ratio of pension pay to working pay, plus the possible impact of changes in pension regulation or in methods of integrating with Social Security.
>
> <u>Actuaries</u> provide
> 1. Projections of the impact of shifts in the age mix of employees, calculations of mortality and disability effects on benefit payments, and estimates of the impact of employee turnover.
> 2. A long term average rate-of-return assumption based on experience of many comparable managed funds of a similar size.

Given this information, management is able to predict the most probable pattern of cost and revenue factors, from which can be projected the annual level of benefit payments, the corporation's funding obligation over the next several years, and the degree of liquidity necessary to ensure the fund's ability to meet the current and immediate benefit obligations.[1]

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[1]Ellis, "Danger Ahead," 55-56.

Although an ever-increasing amount of funds for pension plans comes from earnings on a fund's investments, employer contributions continue to represent the largest single source of income to the funds. Even in contributory plans, in which the prospective pensioner also contributes, the amount is still relatively small. In these plans the employees put up only about $1 for every $4 or $5 contributed by the employer.[1] Looking at all plans, contributory and non-contributory, employee contributions amount to only about 10 to 15 per cent of the total contributions.[2]

The employer has many options in which to finance his pension plan, but in order to be able to take full advantage of tax deductions, he is essentially restricted to the five acceptable basic cost methods described in the Accounting Principles Board Opinion No. 8, "Accounting for the Cost of Pension Plans." These methods can be classified as follows:

1. Individual Level Premium Method
2. Entry Age Normal Method
3. Attained Age Normal Method
4. Aggregate Method
5. Unit Credit Method[3]

A brief description of each method follows. In illustrating the different methods, interest is assumed to be 3½ per cent per annum, the pension is $50 per month, the pensioner was hired at age 25, is now 45, and will retire at age 65. Assuming

[1]Business Week, The Pressure on Pension Funds to Perform, (September 11, 1971), 89.

[2]Metzger, Investment Practices, p. 41.

[3]Paul D. Halliwell, "Basic Principles of Pension Funding and APB Opinion No. 8," Management Accounting, July 1969, 15.

he lives to be eighty years old, the total benefits will amount to $9000. The pension formula used in this case is $1.25 per month for each year of service ($1.25 x 40 years = $50 per month pension).

Individual Level Premium Method. The total amount of money that is required in order for the pensioner to commence receiving his $9000 at age 65 is $6380. The difference will be made up by interest earnings. The employer could decide to deposit a lump sum of $6380 at the time of retirement, in which case he would be using Terminal Funding. Alternatively, the employer could deposit annually into an interest bearing fund an amount that will accrue to the required sum of $6380 at retirement age. In this case, the annual sum required would be $217.97, for a 20 year total of $4359. The difference between this amount and the required $6380 will be made up by interest earnings.

Entry Age Normal Method. Instead of the rigid cost pattern of the previous method, the employer may choose this more flexible method. The employer determines what annual payment would have been necessary to accumulate the required $6380 if he had started contributing when the employee was first employed at age 25. This figure is $72.90 annually. However, since he did not do that, he computes what the present fund balance would be if it had been done, and comes up with $2,133.27, which includes the 3½ per cent interest. The employer then decides to amortize this past service cost; however, in computing his past service costs, he is bound by

minimum and maximum annual amounts set by IRS for tax deduction purposes. The minimum requires that the employer contribute, in addition to the normal cost of $72.90, an amount sufficient to prevent the past service cost from becoming any larger. This additional cost would be 3½ per cent of $2133, or $74.68, for a total annual cost of $147.58 (72.90 + 74.68). The maximum IRS limitation permits a deduction equal to the normal cost plus 10 per cent of the past service cost, in which case the employer could fully amortize the past service cost over a shorter period of time. Once the past service cost has been amortized, only the annual normal cost ($72.90) would remain.

Attained Age Level Method. Here the cost of the employee's benefits assigned to years prior to the inception of the plan is determined to be $25 ($1.25 x 20 years). The past service cost of this obligation is then computed (after discounting back 20 years) to be $1603.20. Added to this total past service cost is the required annual normal costs over the next 20 years of $108.99 annually in order to bring the retirement fund up to the required $6380 at age 65 of the employee. This method is a combination of the Individual Level Premium Method and the Unit Credit Method, which is discussed below.

Unit Credit Method. The only difference between this method and the Attained Age Level Method is the treatment of the normal costs. Under the Attained Age Level Method, the normal cost was level, but under the Unit Credit Method, the normal cost increases each year until retirement age 65 is reached. As the employee completes each additional year of

service, he accrues an additional pension of $1.25 per month. The employer then determines the present value of each additional $1.25 benefit and contributes this amount to the fund. Obviously this is a more expensive method of financing the fund because as each year passes there is less and less time for the interest factor to operate.

Aggregate Method. This method is simply the application of the principles for individuals in the Individual Level Premium Method, applied on a collective basis for all the company's participants. Usually the cost figure is expressed as a percentage of total participant payroll.

Of all the methods described above, the Entry Age Normal Method is perhaps the most widely used.[1] All the methods have to be flexible to the extent that funding requirements are not constant from one year to the next. One company's investment program may provide a return that would enable it to reduce its contributions significantly. A classic example is General Electric Corporation, which is one of the minority of major companies that manages its own pension investments. Although General Electric's pension obligations have almost tripled in the last 10 years, the cost to the company has hardly changed. GE contributed $66 million to its pension fund in 1970, as opposed to $61 million in 1960. The increased funding burden has been almost entirely taken up by return on investments.[2]

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[1] Ibid., 15-19.

[2] Business Week, The Pressure on Pension Funds, 92.

On the other hand, some companies have to compensate for a drop in asset values and investment return by increasing their pension contributions. Most plans take the cyclical action of the stock markets into account by allowing sponsors to average investment results over two or three years, damping the impact of both short-term declines and advances.

Besides looking to increased investment earnings as a means of reducing corporate contributions, companies are also asking for more and heavier contributions from prospective pensioners. As stated previously, employee contributions today account for only about 10-15 per cent of the cash flow into pension funds, but the contributory funds are growing rapidly. In support of this effort, the Association of Private Pension and Welfare Plans is urging the government to encourage this trend by making the employees' pension contributions tax deductible, as the employers' now are.[1]

Up to this point in the investigation of pension funds, the discussion has centered around the history, purposes, types and funding methods of pension plans. Very few problems have been brought forth and certainly no solutions to the contemporary issues that are currently being widely discussed. The next three chapters will attempt to elaborate on these contemporary issues and how corporate management is attempting to keep pace with the changing scene by constantly reviewing and changing their policies, practices, and objectives in the

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[1] Ibid., 98.

administration of their pension plans, for the benefit of the firm itself as well as for its employees.

CHAPTER III

ADMINISTRATION AND MANAGEMENT OF PENSION FUNDS

GENERAL DISCUSSION

It has already been established that corporate pension funds are the largest single source of capital in the country today, almost five times larger than the total of all the nation's mutual funds put together. Additionally, these funds are almost certain to grow at an increasing rate as the pressures for more pension benefits come to bear on the companies. In 1970, company-sponsored plans paid $6 billion in benefits to 4.2 million pensioners - yet assets set aside against future demands still increased by $9 billion. So, even as present benefits continue to increase, the total assets also increase.[1]

The above figures may be misleading in that current and previous years results have very little bearing on future requirements in this constantly changing business. Last year's figures may be impressive, but what really is important is what the conditions will be in the next two decades. Using that time frame as a gauge, the large amounts of pension money may not be large at all, and may even be too small. So, with

[1]Business Week, The Pressure on Pension Funds to Perform, 88.

the evidence that expectations and demands of prospective retirees are growing faster than the funds available to meet them, pension fund administrators not only have to continually reevaluate their programs, but must be very sensitive to change. The following quote, taken from the Report by the Subcommittee on Employment and Retirement Incomes to the Special Committee on Aging, United States Senate, June 1965, sums up the nationwide concern for after-retirement income:

> "America has a long way to go toward adequate incomes for its elderly, and it needs to take maximum advantage for every possibility toward this objective. Our private pension system is a useful tool in producing adequate incomes for the later years, and it behooves us to use it imaginatively and unsparingly."[1]

The prevalent feeling among those concerned with pension planning is that most companies are currently funding their pensions to provide for no more than the present schedule of benefits, and that the corporations were contributing far too little to their funds when corporate earnings were high and they could have afforded it. The point is that when profit margins are lower, funding requirements will almost certainly increase and the company will find it harder to bear the burden then. The present planning then, has oversights in that it understates the size of the pension liability being incurred now and it forces the companies to "play catch up ball" later.[2]

The asset manager of a pension fund has a definite obligation to attempt to widen the possibilities of expanding

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[1]Metzger, Investment Performance, p. 1.

[2]Ellis, "Danger Ahead," 53.

pension payments to the employees covered by a fund and those expected to be covered by it, while minimizing the burden that might be imposed on the shareholders of the firm (in the form of reduced earnings per share). This obligation however, is subordinate to the objective of meeting the established yield requirement set forth by the actuary.[1] Accomplishing all these goals is admittedly difficult, but the funds have altered the previously prevailing practice of conservative investments, which not only missed opportunities to hedge their funds against inflation, but they also incurred higher costs than necessary. This alteration of policy has been in the form of increased growth of common stocks as an investment medium.

A pension fund and its investment program is obviously a long term proposition, and in planning the administration and management of the fund, the manager must analyze long term fund needs and resources, and just who in particular is going to manage these funds. In previous years the pension plans were handled almost exclusively within the corporate structure itself, but the more recent trend has been to give the investment responsibility to outside managers. The use of outside managers can be in the form of using just one manager, or the funds can be split up between two or more managers. In this way, the company can give more or less money to each fund manager depending on what his performance is, or it can drop him altogether if his performance is consistently below standard. The majority of pension assets are managed by

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[1]Croot, "Declining Asset Values in Pension Funds," 20.

banks, but mutual funds, insurance companies, and more recently, even brokerage houses have entered the field of pension fund management. This is not to say that the companies have turned over investment responsibility to outside managers entirely. A common practice among corporations is to have the outside trustee plus a corporate advisory board handle the administration and investment of their funds, with responsibility over selection of individual fund holdings almost evenly divided between the trustees and parties within the company.[1]

The managers of these funds, whether inside the company or external to the firm, must be guided by the consideration that while, for most pension funds, assets and increments to them in the form of contributions and yield are more than adequate to meet short term obligations (up to five years), they are much less than will be required to satisfy obligations that will arise in the future: ten, twenty or thirty years later. It therefore follows that the time horizon of a pension fund's asset manager should not be the next quarter or the next year, but ten, twenty, and thirty years ahead, and that asset management must be predicted on a ten-year, twenty-year, and thirty-year basis (the last being the period to maturity of most corporate bonds).[2]

Different pension funds will have different claims that must be honored over different periods of time. The incidence

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[1] Metzger, Investment Performance, p. 170.

[2] Julian Gumperz, and Everett W. Page, Jr., "Misconceptions of Pension Fund Performance," Financial Analysts Journal, May-June, 1970, 72.

of these claims will have an impact on the types of investments that will be possible and when they are possible. There are certain constraints that a pension fund manager must contend with when making investment decisions, depending on the particular fund involved. Some of these constraints are:

Marketability. This consideration is very important when the benefits provided by a pension fund are fixed and enforceable by law or union contract, and when the current and immediately prospective claims upon a fund are large relative to annual contributions. In this situation, the marketability of the fund assets and the degree of ability to convert them to cash and other assets is a very limiting constraint on investment policy.

Risk. This constraint applies to both market risk and business risk. If a fund's resources are small relative to prospective demands upon it, high-risk investments must be avoided. However, most funds are large relative to current demands, so the volatility and short term variability of market prices is not of significance. The element of business risk, which is the matter of how the company, and not its securities, fares over time, is much more important. It concerns the company's ability to cover interest payments, amortization charges, principal on maturity; in other words, its ability to survive.

Timing of Yield. There is a tendency for corporate management to encourage asset managers to strive for as high a yield as possible, thinking that this would enable them to

reduce their annual contributions necessary to maintain adequate funding. The problem with this policy is that any sustained rise in yield will raise expectations of employees for increased benefits. If these liberalized benefits are realized through union negotiations, management, by pressing for the higher yields, is, in effect, deferring pension costs into the future and must eventually increase its annual contribution. This can be very detrimental when negative earnings or negative yield coincides with rising liabilities. The Studebaker Corporation case is a classic example of this occurrence where declining earnings, and then severe deficits, came up against rigid pension fund liabilities, causing its pension fund to become deplete and thus deprive many of its employees of their deserved pensions.[1]

With all the above constraints, considerations, and alternatives, the problems of pension fund administrators loom even larger. There evidently is no one absolute direction for these managers to take, but there certainly must be one that is most right for the company concerned. The main element that is necessary is that management should not be forced to decide either yes or no on any one particular investment program. There should be a variety of relevant alternatives available from which can be selected an optimum program of funding and investing assets. The right direction must be primarily determined by the nature and requirements of the fund that is being managed, and not primarily by the standards of measure-

[1]Ibid., 73.

ment set up by outside observers. Once the investment and funding decisions are made, investment management must keep tuned with changes, and should require regular reviews of the program, with a view toward investment results that would make it possible to either decrease the required contributions from employers or to increase benefits to employees, or some combination of both. In his attempt to enhance the economic value of the assets of a fund, the manager must invest these assets in situations with respect to what is happening fundamentally in technology, markets, government, and deeper still, with respect to changes in knowledge, taste, and temper of our times, and that the probabilities are maximized that the value of the assets will be preserved.[1]

INVESTMENT OBJECTIVES AND POLICIES

Objectives

Every trust fund's objective is obviously the maximization of the value of the fund. It is apparent however, that this objective is really composed of two lesser objectives - safety of principal and maximum potential for gain, which, unfortunately, are contradictory to each other.[2] It is imperative then, that the corporation take definite and positive early steps in deciding on a specified objective or combination of objectives.

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[1] Ibid., 76.

[2] Metzger, Investment Performance, p. 218.

The first step in a firm's determination of investment objectives for its pension program is an examination of the benefit and contribution schedules.[1] The results obtained from this examination will determine what the fund's goals are. The goals can take the form of (1) maximum long-term return on investment without undue risk, (2) maximum growth, (3) maximum current income, or (4) any combination of the first three.

Long term objectives are the determining factors in any decision made by fund managers, but these long term objectives can possibly be achieved by short-term decisons and trade-offs. An asset manager may decide to accept the chance of short-term deterioration of value in <u>some</u> of the fund's assets if there is a relativly high probability of recovery of value for <u>most</u> such assets, and of a rise of value for the totality of fund assets over the longer term.[2] In this regard, separation of investment objectives may become important. A corporation may decide to call on more than one outside advisor to handle the pension funds, each with different sums of money to invest and each armed with different objectives. Regardless of any possible combination of objectives, or single objective if that is the case, the achievement of the maximum total earnings for each dollar of contributions over the longest possible term, consistent with safety requirements, is the definite overriding goal of any pension plan.

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[1]Bennett S. Kopp, "Managing Pension Portfolios to Meet Increasing Future Costs," <u>Commercial and Financial Chronicle</u>, August 13, 1970, 18.

[2]Gumperz and Page, "Misconceptions," 32.

Policies

Before a firm can decide on what its pension fund management policies and objectives are going to be, it has to first decide who is going to set the policies, what authority this individual or group will have, and where this aspect of the firm's operations will fit into the overall corporate structure. In order to meet the challenge of pension fund operations, the trustee must be organized; organized in the sense that the attitude and flexibility of the investment committee, the setting of realistic and attainable goals, and the stimulation of the investment personnel are all such as to enhance the achievement of the fund's objectives. The attitude of the policy-making committee has much influence on the overall operation of the fund, it can either be of immeasurable assistance in producing satisfactory results or, because of lack of interest and initiative, it can be a deterrent to the achievement of specified goals.[1]

The investment of funds by any individual, group, corporation, or trustee involves a constant review and update of investment policies. The challenge and opportunities that continually present themselves in the changing money markets are reason enough for managers to constantly review their procedures. In the pension fund field in particular, the most significant trends in pension investment policies have been the following:

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[1]Charles A. Pingree, "Organizing for Investment Performance," Pension and Welfare News, May 1969, 38.

1. broader diversification of holdings

2. more aggressive investment posture

3. increasing investment sophistication among fund managers

4. more widespread retention of outside investment advisors

5. intensified seeking out of investment opportunities that would improve investment performance

6. greater sensitivity to market conditions when making investment decisions.[1]

The reasons for this drastic change from conservative to aggressive policies has already been discussed. Even within the new policy structure itself, there is even more cause to constantly review the investment program. Obviously, the prospect of a bear market, a bull market, or a static market, all have different implications, and the effects of these implications must be contended with.

A very important aspect is just how the company looks upon the management of its pension fund and how it fits into the corporate structure. Good long-term investment results, whether they be capital investments or pension fund investments, can make a significant difference in corporate earnings by its effect on earnings per share. It has already been established that a pension fund is a very definite long term investment for most companies, and therefore does not have to rely on short-term results or on current income to meet benefit obligations. With this in mind, a corporation's top management should require the same aggressive, profit-oriented management

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[1]Metzger, Investment Performance, p. 402.

for the pension fund as it does in the operating divisions, and should accept comparable interim risks to achieve comparable long-term profit rewards. In other words, the companies should, and evidence shows that they do, look at its pension fund as a competitive user of capital to be rigorously compared with the other operating divisions that also use the firm's capital.[1]

In selecting the investment advisor, or advisors, the corporation must not only consider who should be the best choice, but also how many advisors should be used. The trend is toward the use of more than one advisor, but some firms are still reluctant to use any outside advisor at all, preferring to make their own investment decisions. Even in these companies, the decisions are not made by any one individual, but rather by a committee, consisting of three or four individuals who discuss and decide what investments should be made and what areas should be concentrated on.

As stated, most firms are utilizing outside advisors. Before selecting any advisors, the firm must first decide what its objectives are and what group of outside advisors are best qualified to handle the firm's portfolio. In choosing the advisors, past performance should be the main criteria. The number of advisors chosen will of course depend on the size of the fund involved, but generally speaking, if the company selects more than a limited number of firms, the results would probably be closer to that of the universe of all stocks. On

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[1]Ellis, "Danger Ahead," 53.

the other hand, selection of one manager might be too great a risk if that advisor were to make a major mistake in its philosophy about the economy or the market.[1]

If the trustees, as the investment managers, are to be tasked with providing the greatest possible total rate of return, and are being held responsible for that task, it is imperative that they be given complete authority to buy, sell, or retain those securities they feel to be best suited for the accomplishment of the objectives. For a corporation which is accustomed to handling its own pension fund investments, this delegation of authority may be very difficult to accept, but it is evident that more and more companies are doing just that in their quest for the best investment advice they can obtain for their programs.

Conversely, if the corporations are going to entrust their funds to these professional investment counselors, it is the duty of these outside advisors to do their best to prudently balance a basic policy of preserving the value and purchasing power of the company's principal, while at the same time maintaining an aggressive philosophy aimed at securing growth of capital and increased income when this can be accomplished without undue risk.[2]

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[1] William A. W. Stewart, III, "Splintering Pension Funds For Outside Management," Pension and Welfare News, December, 1970, 60.

[2] John D. Bagnall, "Alternatives in Investment Management," Pension and Welfare News, December, 1970, 36.

Federal tax laws have a large amount of influence and impact on just how policies and obligations are set by fund managers, and carried out by investment advisors. The funds are allowed favored tax treatment, but must meet strict criteria concerning the handling and accounting for assets before qualifying for this favored treatment. With regard to tax laws, the investment advisors are given some flexibility in stock trades in that the pension fund account is not like an individual account, and there's no reason for not selling stocks that have advanced over a short time period since short term gains or losses are not factors to be considered.

One highly important factor in the making of investment policy that has been mentioned briefly previously is the subject of liquidity. The investment trustee must know what the need for liquidity is and how much liquidity is necessary for a particular pension fund. The corporation must have an almost infallible understanding and knowledge of what its current cash needs are and it must impart this information to the trustee. Many corporations are invested entirely in highly liquid investments, and unnecessarily so. These are not always the highest rate of return investments.[1] The wrong balance of liquidity in its investments can cost a firm money. If the investments are too liquid, a lower return is probably the result. On the other hand, if a firm's portfolio does not have the liquid investments necessary to meet current needs, it will lose

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[1]Forbes, As I See It, November 15, 1971, 72.

money by having to convert these investments to cash at what might be an inopportune time.

A word is necessary at this point to discuss briefly the possible limitations that are connected with the recent policy change to more aggressive investment postures. The effort to substantially increase returns on investments takes on two facets: current yield, in the form of interest, dividends, rents, royalties and other earnings on assets; and, capital gains on sale of assets.[1]

The current yield aspect has two limitations. Recent high rates of interest have presented a great opportunity for higher yields, however, only recent and current income could have been invested at these high rates, previous income being locked into debt instruments that yield much lower rates of return. Additionally, the improbability, and the undesirability, that these high rates will persist means that the large pension funds cannot count on achieving and maintaining these high yields. Returns on large and diversified stores of securities cannot, on the average and in the long run, exceed the rates of return on capital characteristic of an economy at each stage of its development.[2]

The search for capital gains resulted from this appreciation of the limited potential of yield. Unfortunately, although many paper gains are made, when the attempt is made to realize these gains by selling, the prices of the issues would

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[1]Gumperz, "Pension Funds in an Age of Discontinuity," 120.

[2]Ibid.

most likely drop significantly. It is entirely possible that "performance" oriented investors, including the investment managers of pension funds, by their aggressive practices, can bid up the price of issues beyond all reason, only to have the opposite effect take place when an attempt is made to sell the issues.[1]

The apparent high yield available and apparent capital gains made can mislead a corporation into thinking that assets have increased, thereby allowing a reduction of contributions. This can have very detrimental long term consequences.

EMPLOYEE, MANAGEMENT, LABOR UNION CONSIDERATIONS

Having looked at the general administration, management, and policy making aspects of corporate pension funds, it is well now to devote some attention to the internal and external influences that affect the administrative and policy decisions that are made. At the present time the U. S. government has not gotten deeply involved in the regulation and control of corporate non-insured pension funds; however, it has provided for the registration, reporting, and disclosure of employee welfare and pension benefit plans in the form of "The Welfare and Pension Plans Disclosure Act, As Amended."

Having recognized that pension plans affected, (1) the well-being and security of millions of employees, (2) the stability of employment, (3) the national public interest, and (4) the successful development of industrial relations, Congress

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[1] Ibid.

acted to provide for the general welfare and the free flow of commerce by certain disclosures made by corporations with respect to the operation and administration of such plans.[1] The essence of this Act is to require that the administrator of an employee welfare benefit plan or an employee pension benefit plan shall publish to each participant or beneficiary covered thereunder (1) a description of the plan and, (2) an annual financial report. The description shall include a complete schedule of benefits, the names and addresses of trustees, the source of financing, etc. The annual report shall include the amount contributed by the employer and a statement of assets specifying the total amount in cash, bonds, stocks, loans, etc.[2]

The single most important group of assets that any organization has are the employees that work for it. Without the sincere and conscientious efforts of its employees, an organization is doubtful of success and maybe even survival. In any economic climate, the young company, in particular, which hopes to grow and prosper wants to attract, train, and retain new employees as well as to hold on to more experienced workers. An attractive profit sharing or retirement pension plan can be a powerful force in this regard. One of the most important concerns for an individual is for the future security of himself and his dependents, and the better, more secure a pension plan is, the more apt a company will be able to attract and

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[1] The Welfare and Pension Plans Disclosure Act, As Amended, sec. 2, 1, 1962.

[2] Ibid., sec. 6, sec. 7.

retain these necessary individuals. A study made by the Monthly Labor Review reported that turnover rates were notably lower - for both younger and older workers - in firms that had private pension plans than in those that did not.[1] Corporations cannot overlook this implication of a good pension plan.

How much pension should or would be the desirable level for an employee after retirement? The variability of the answers to this question is wide but there is almost universal agreement that a pension arrangement ought to enable a retired employee to maintain a level of living consistent with his contribution to the productive process. According to most experts, this would mean a pension equivalent to anywhere from 50 to 100 per cent of the final or maximum pay received by the pensioner before retirement. The expansionists in social security argue for a level close to final take-home pay, adjusted to inflation. This compares with the average pension of the retired American today of 25 per cent of his terminal or maximum salary or wage.[2] To raise the pension benefits to higher levels would be an extremely expensive sacrifice in the form of higher corporate contributions, plus almost certain greater payroll deductions, resulting in a decline of spendable income for the employee.

There is generally no argument against the United States being able to afford higher pension standards for its citizens.

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[1]Paul P. Harbrecht, S. J., "Pension Funds and Economic Power, (New York: The Twentieth Century Fund, 1959), p. 55.

[2]Burck, "The Ever Expanding Pension Balloon," 100.

The imbalance between the incomes of working and pensioned Americans must be adjusted and compensated for at a rate that workers, and particularly, labor unions, will stand for. More important, the higher standards will have to come gradually. The labor unions are blamed for reducing the nation's ability to pay more generous pensions because of the stands they have taken in recent labor negotiations. In some cities and industries, policemen, garbage men, steel, and auto workers have already won contracts that allow them to retire at half pay after twenty years, and are asking for full pay after forty years. The reduction in retirement age from 65 to 60, and to even 55 as some desire, cannot possibly be offset by any foreseeable productivity gains.[1] Add to this the possible loss of productivity if the trend toward the 4 day-40 hour week continues.

Nevertheless, the major labor unions are pushing ever further in their demands for increased pension benefits. Pension plans are a built-in fact of corporate life and their terms and benefits are almost always an integral part of any labor-management bargaining when contract renewals come up. Also, the use of a profit-sharing plan, whose costs are more related to company profits, in lieu of a pension plan is frowned upon by labor leaders. Today's labor leaders generally distrust the employer's computation of profits, and furthermore, the whole idea of profit-sharing is repugnant to some labor leaders who try to discourage the mutuality of interests between employer and employee. Pension plans are

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[1]Ibid., 102.

more desirable by the unions because the benefits can be definitely defined in every economic climate, regardless of the profit picture.[1]

Of the government, employee, and labor implications discussed above, the corporation is probably more restricted and influenced by labor union demands than the others. However, there are signs of increasing concern on the part of the government, which will be elaborated on in Chapter V. Regardless of where or from whom the pressures come from, management has to consider all of them in its process of selecting between various possible policies and objectives in the administration of its particular pension fund.

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[1]Holzman, Guide to Pension and Profit Sharing Plans, p. 60.

CHAPTER IV

PENSION FUND INVESTMENTS

INVESTMENT PORTFOLIOS

Just as different cost and contribution figures and patterns have much influence on the basic investment policies and objectives of a pension fund, so also do they influence the investment strategy and composition of the investment portfolio of the fund. And because these cost and contribution figures are constantly changing, the structure of almost all pension fund portfolios has also changed over the past ten to twenty years.

At the beginning of the Fifties, trustees managing non-insured corporate pension funds had about one third of their assets in United States government securities, 45 per cent in corporate bonds, and only about 12 per cent in common stocks. By 1960, less than 5 per cent was invested in government securities, about 40 per cent in corporate bonds, while the share allotted to common stocks had risen to over 40 per cent. Five years later in 1965, the relative figures had changed again, with common stock getting still a greater share of pension fund capital.[1] Table 2 shows the breakdown

[1] Metzger, Investment Performance, p. 41.

TABLE 2

PERCENTAGE DISTRIBUTION OF CORPORATE FUNDS BY HOLDINGS
1951 - 1965

Holding	1951	1960	1965
Cash and Deposits	4.1	1.3	1.1
U. S. Government Securities	31.4	6.2	3.6
Corporate Bonds	44.7	40.2	30.0
Preferred Stock	4.0	1.9	1.2
Common Stock	12.3	43.9	56.2
Mortgages	0	2.7	3.9
Other Assets	3.5	3.8	4.0
Totals	100.0	100.0	100.0

Source: Securities and Exchange Commission annual reports on "Noninsured Corporate Pension Funds."

of the assets of non-insured Corporate Pension Funds by holdings during these time periods.

As can be seen from the table, every holding decreased percentage-wise except for mortgages and common stock. Mortgages (FHA, VA, conventional residential, and income and industrial real estate) have become increasingly attractive to pension fund managers.[1] But the big story revolves around common stock. The figures shown really do not show the entire picture in that much of the funds controlled by these institutions are locked into long term securities, and cannot readily be converted to common stock. However, new funds coming into the plans are being invested in common stocks at even higher percentages. As late as 1969, emphasis on common stock reached a peak when 85 per cent of the inflow of new capital was invested in stocks, and the total of common stock holdings was about 65 per cent of all pension fund holdings.[2]

The reasons for this trend toward increased holdings in common stock have been discussed previously but bear repeating again. The primary reason is probably the diligent quest of fund managers for capital appreciation and future earnings growth, but almost equally important are the higher yields available on high grade equities over fixed income alternatives and the "hedge against inflation" argument.[3]

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[1]Bert L. Metzger, "Investment Management of Pension and Profit Sharing Trust Funds," Pension and Welfare News, August, 1969, 44.

[2]Gordon L. Bowyer, "1970, Year of Opportunity for Pension Fund Investment," Financial Executive, September, 1970, 47.

[3]Metzger, Investment Performance, p. 41.

General Electric, mentioned previously as one company that manages its own pension investments, has drastically moved away from bonds toward common stocks, which now makes up 65 per cent of its portfolio. It has also put money in oil wells, mortgages, venture capital deals, and even post offices, bought and leased back to the Postal Service. In 1970, the cash flow from these investments alone covered the entire $83 million that was due the pensioners, proving the success of the more aggressive and less conservative investment policies of the company.[1]

Devoting some attention to the equity holdings themselves, the fund managers are more notable for the large number of individual investment choices than for any concentration in a few companies. For example, in a recent survey, there were only four companies whose stock was held by 30 or more of the 49 funds surveyed, and only 44 stocks were held by as many as ten of the funds. On the other hand, 260 stocks were held by only one fund each, and another 109 stocks by two funds. The front runners, both in the number of funds holding and in aggregate market value, are the classic favorites of all institutional investors; IBM, General Motors, Texaco, Xerox, General Electric, Eastman Kodak, Standard of New Jersey, ATT, Gulf Oil, Sears, and Minnesota Mining. But, not unlike other institutions, such as mutual funds, the trend toward performance is also evident in such popular holdings as Litton

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[1]Business Week, The Pressure on Pension Funds to Perform, 95.

Industries, National Cash Register, Occidental Petroleum, Magnavox, Texas Instruments, Sperry Rand, and other more volatile stocks.[1]

Another influencing factor that has resulted from this change of pension fund investment philosophy is the effect on the markets. Because the funds are investing a higher percentage of net receipts in common stock and because of the accelerating activity within their portfolios, the trading of large blocks of stock by one or more funds at the same time will produce greater price swings than would normally be the case. Unlike performance-oriented mutual funds, most pension funds still have a strong tendency to "buy and hold," but there is much more trading proportionally in these funds than there was 10 to 20 years ago.[2] The fact that ever increasing amounts of new funds are being used to purchase common stocks involves a built-in increase of trading activity, but figures reveal also a marked relative increase in sales transactions. Table 3 shows the common stock transactions of pension plans from 1953 to 1965.[3] As can be seen, the ratio of purchases to sales has decreased markedly, and although later figures than those for 1965 are not presented, it can be expected that the ratio will continue to decrease

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[1]Pension and Welfare News, Surveys of Pooled Pension Fund Holdings, May 1969, 54-58.

[2]Metzger, Investment Performance, p. 41.

[3]Jerome B. Cohen, and Edward D. Zinbarg, Investment Analysis and Portfolio Management, (Homewood, Illinois: Dow Jones-Irwin Inc., 1967), p. 722.

TABLE 3

COMMON STOCK TRANSACTIONS OF TRUSTEES PENSION PLANS

Year	Purchases	Sales	Net Purchases as % of Net Inflow	Ratio: Purchases to Sales
1953	513	74	23.8	6.9
1954	738	148	31.3	5.0
1955	858	249	28.7	3.4
1956	1000	229	32.3	4.4
1957	1186	208	36.5	5.7
1958	1527	335	43.0	4.6
1959	2207	544	50.9	4.1
1960	2441	625	51.2	3.9
1961	3440	1170	62.4	2.9
1962	3205	995	58.3	3.2
1963	3760	1555	55.8	2.4
1964	4375	2105	51.2	2.1
1965	5585	2560	59.8	2.2

Source: Securities and Exchange Commission, "Annual Survey of Pension Plans."

as pension fund managers step up trading activity in the desire for improved investment performance.

INVESTMENT PERFORMANCE

A keen and increasing interest in the subject of pension fund investment performance has developed among corporate financial officers having responsibility for the administration of pension funds and among the trustees with whom these funds have been entrusted. The primary force in this interest is a result of the urgency of controlling the cost of retirement benefits, but the increasing awareness also results from rising living costs, which force negotiated benefits higher, and shrinking profit margins. This recent trend toward performance is causing these administrators to realize that even a small increase in such performance can well offset the effect of future benefit increases as well as reduce present contributions to the pension plans.

The need for good measurements of investment performance is self-evident. Being the fastest growing pool of financial assets in the United States, the magnitude and importance of pension funds impose responsibilities not only upon private corporations, actuaries, accountants, investment counselors, and trustees, but also the federal government. It is of utmost importance to the expected recipients of these funds that these assets be managed efficiently and safely if their expectations of future financial independence are to be realized. It is equally important to all Americans

that these economic resources be effectively managed, and if asset management is to be effective, it is necessary to have a sound basis for investment evaluation.[1]

Pension funds have been under some scrutiny in recent years because of the overall performance of their investments. It is generally agreed that pension fund assets should earn dividends and appreciation at least equal to the market as a whole. Yet, when measured against some of the leading market indicators, such as the Standard and Poor 500 Stock Index, the rate of return on the equity portion of many pension funds persistently lags behind.[2] It must be made perfectly clear at this point however, that investment performance of a pension fund is important only inasmuch as it demonstrates the meeting or surpassing of a specified goal or goals. It should not be used in any other context.

There are obviously many schools of thought concerning what should be the criteria of measuring investment performance. Among the many points of view, and considerations are:

1. overall, or total, rate of return

2. volatility of rate of return

3. selection of securities in the fixed and variable portions of the entire portfolio

4. timing of investments between fixed and variable return securities.

In order for a performance index to be accurate, it must combine current yield on the securities owned with the

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[1]Peter O. Dietz, "Evaluating the Performance of Pension and Profit Sharing Trusts," in Metzger, Investment Performance, p. 550.

[2]Croot, "Coping With Declining Asset Values," 27.

increase or decrease in the market value of those securities over the period being studies, it must adjust for company and employee (if any) contributions, and, to be of value in comparison, the measurement must be over a period of time, including several business cycles.[1] Additionally, a fund's performance should be judged also by the values that are realizable in the marketplace, and the degree of confidence that present values can indeed be expected to be realized if an augmentation of funds is needed. Book value of assets should be irrelevant, and there should be no distinction between income and principal, nor between realized or unrealized capital gains. What really is important is the amount of dollars that a fund can come up with if all the assets were sold.[2]

The concept of total rate of return has evolved almost universally as the standard measure of evaluating the performance of various portfolios. Of course there are variations of computing total return, but as long as the same criteria is used when comparing different investment vehicles, the end result should be the same. Perhaps the most widely known definition of total return is that supplied and used by the Profit Sharing Research Foundation (PSRF), one of the foremost groups involved in the evaluation of corporate pension and profit sharing plans. PSRF defines total return as follows:

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[1]John M. Tuttle, "The Use of Investment Counsel by Profit Sharing Trusts," in Metzger, Investment Performance, p. 514.

[2]Gumperz and Page, "Misconceptions," 74.

"Income from dividends, interest, and rent," divided by the average of total market value (MV) of fund equity at beginning and end of year less one half of investment income, <u>plus</u> "gains (losses) realized and unrealized," divided by the same base.[1] In equation form, total return equals:

$$\frac{\text{Income} + \text{Gains (Losses)}}{\left(\frac{\text{Beginning MV} + \text{Ending MV}}{2}\right) - \frac{1}{2}\,(\text{Income})}$$

This can admittedly become somewhat complicated, yet is probably the most accurate determination of total return. There are still other more sophisticated methods and some less sophisticated, but it is not the purpose of this paper to delve too deeply into the methods of measurement of rate of return. It is important to note however, that measurement of the rate of return should not be the only measurement criteria. Returns from investments must be compared against risk. Once the element of risk has been determined, perhaps even quantified, either over-emphasis on return or ultra-conservative investments will become apparent, and can hopefully be corrected.

The task of accurately pinpointing the investment performance of a specific pension fund over a specific period of time is an almost impossible one. Securities and Exchange Commission regulations do not require that the companies reveal performance figures, and most choose not to do so for various reasons. Various publications and organizations have

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[1]Bert L. Metzger, "Investment Management of Pension and Profit-Sharing Trust Funds," <u>Pension and Welfare News</u>, August, 1969, p. 50.

their own methods of evaluating the performance of these funds, some using total return, some including capital gains realized only, and some using income return only. Comparisons are usually made with the popular indices and with other pension funds rather than with mutual funds because mutual funds have entirely different objectives, even within the mutual fund category itself, and most mutual funds certainly are not investing for long term results.

One figure that has been suggested as a satisfactory objective for pension fund performance is a 12 per cent compound rate of return over a five year time span. This figure may seem arbitrary, but it relates to certain historical data in the following ways:

1. It is more than twice the average yield of 5.63 per cent obtained on Moody's triple B utility bonds for the five year period ending December, 1968.

2. It is double the generally accepted estimate of a sustainable growth rate for the national economy.

3. It compares with an actual figure of 7.7 per cent for the Dow Jones Industrial Average for the five year period ending December, 1968, and would be sufficient to produce additional incentive trustee compensation under many of the present formulae for those who are thinking along these lines, and,

4. The return on net worth for manufacturing concerns from 1963 to 1967 ranged from 10.3 per cent to 13.4 per cent, to average exactly 12 per cent.[1]

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[1]Pingree, "Organizing for Investment Performance," 39.

Looking first at the rate of return on income alone, Table 4 shows the income return of corporate pension funds and how it compares with the average yield that was available through Savings and Loan Associations and Mutual Savings Banks. It is obvious that the return of the pension funds was consistently less than that available through Savings and Loan Associations, but varied somewhat in comparison to return on Mutual Savings Bank accounts.

Table 5 shows the recent results of particular pension funds within particular industries, plus 26 large, balanced mutual funds. All the pension funds in this comparison are self-administered and do not utilize the services of any outside investment advisors. The gross return indicated is computed by the total of investment receipts and capital gains (losses) realized divided by total assets. The result does <u>not</u> include capital gains (losses) of assets still held by the funds. The fact that the banking industry is able to attain higher performance with their own funds is not surprising since bank trustees generally have much more investment experience and they themselves are used quite extensively by those funds that do employ outside advisors. A valid assumption can therefore be made at this point that, generally speaking, those companies that utilize investment counsel would normally show better pension fund investment performance than those firms that administer their own investment programs.

Table 6 shows the average annual rate of return on investments of non-insured corporate pension funds by source

TABLE 4

COMPARISON OF NONINSURED CORPORATE PENSION FUND INCOME RETURN WITH SAVINGS AND LOAN ASSOCIATION AND MUTUAL SAVINGS BANK INTEREST RETURN

Year	Pension Fund Income Return	Savings and Loan Interest Return	Mutual Savings Bank Interest Return
1956	3.96%	5.15%	3.65%
1957	3.83	5.25	3.80
1958	4.30	5.34	3.92
1959	4.45	5.46	4.08
1960	4.35	5.61	4.25
1961	4.80	5.71	4.41
1962	4.36	5.87	4.56
1963	4.49	5.85	4.68
1964	4.93	5.93	4.79
1965	5.22	5.91	4.89
1966	4.99	5.97	5.02

Source: Securities and Exchange Commission, Federal Home Loan Bank and National Association of Mutual Savings Banks.

TABLE 5

ASSETS AND GROSS RETURN OF SELF-ADMINISTERED PENSION FUNDS

Industry	Number of Funds Reporting	Total Assets ($Million)	Gross Return(%)	Year Result Reported
Banking	25	1,139	4.81	1967
Textile	25	500	4.54	1968
Communications	25	6,270	3.99	1967
Aerospace	22	1,000	3.90	1968
Petroleum	25	2,430	3.91	1968
Utilities	25	1,000	3.80	1969
Retailing	25	3,860	3.72	1969
Insurance	25	210	3.66	1969
Plastics/ Rubber	25	708	3.63	1968
Transportation	25	1,250	3.55	1969
Publishing	25	250	3.40	1968
Mutual Funds	26	9,000	3.30	1968

Source: Pension and Welfare News, May 1969 to June 1971.

TABLE 6

AVERAGE ANNUAL RATE OF RETURN ON INVESTMENTS
OF NON-INSURED CORPORATE PENSION FUNDS
BY SOURCE AND BY PERIOD

Source of Return	1959	1960	1961	1962	1963	1964-1966
Investment Income	3.58	3.64	3.47	3.48	3.53	3.52
Capital Gains	2.32	2.27	10.64	-6.11	7.32	0.48
Total	5.90	5.91	14.11	-2.63	10.85	4.00

Source: Profit Sharing Research Foundation.

and by period. The total return is broken down into investment income and capital gains, both realized and unrealized. The results shown are the averages for both self-administered funds and funds which utilize outside advisors. It is apparent from the results shown that up to 1961, the capital gains income for the funds was only nominal, indicating very little trading activity in the markets. From 1961 on, the funds obviously took a more aggressive attitude toward common stock investments as evidenced by the greater volatility of the capital gains and losses. The investment income from dividends, interest, etc., remained steady throughout the periods shown.

Table 7 shows a comparison of the results of Table 6 with the annual change of the New York Stock Exchange Index, thought to perhaps be the best indicator of stock market actions since it averages all the stocks listed on the New York Stock Exchange. These results show that in 1961, when the funds became more active in the markets, the rates of return of the pension funds started to make wider swings, but still not as wide as the NYSE Index, indicating that although the funds did become more active, they were still basically more conservative in their selection of investments. Eliminating the years 1959 and 1960 because of the nominal stock holdings of the funds, a comparison of the average return between 1961 and 1966 shows that the pension funds averaged an annual return of 5.72 per cent, whereas the NYSE Index increased an average of 6.85 per cent annually.

TABLE 7

COMPARISON OF PENSION FUND TOTAL RATE OF RETURN AND PERCENT ANNUAL CHANGE OF NEW YORK STOCK EXCHANGE INDEX

Year	Pension Fund Total Rate of Return	NYSE Annual Change
1959	5.90%	3.8%
1960	5.91	0.0
1961	14.11	26.6
1962	- 2.63	-13.1
1963	10.85	15.3
1964-1966	4.0	4.1

Source: Profit Sharing Research Foundation.

The data presented suggest that there is considerable room for improvement in the investment management of most trusts. Certainly the New York Stock Exchange Index of all listed stocks can be improved upon by capable management, and there is no reason why the pension fund returns should not only at least equal the long term performance of the Index, but even surpass it by many percentage points. The quest for superior performance, which is being witnessed today, insofar as it is based on sound values and solid earnings growth, is both justified and overdue.[1] Such are examples of criticisms currently being directed at pension fund management.

Are these criticisms justified? Performance measurements are meaningful, and should command the attention of corporate management, but only insofar as it relates to the requirements and objectives of particular funds. It is evident that performance comparisons must take account of rate of growth of the fund, timing of cash flows, and if possible, the level of risk incurred in achieving a given rate of return.[2] This is not to say that portfolio managers should purposely set low objectives so that they can more easily be achieved. Corporate management should be vitally concerned with the dollars and cents implications of investment performance. It is generally understood and agreed that a difference of one per cent in rate of return on a retirement fund may permit a 20 to 25 per

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[1]Metzger, Investment Management, p. 52.

[2]Roger F. Murray, "A Yardstick to Measure Pension Fund Performance," Banking, June, 1969, 50.

cent reduction in contributions over a period of time, assuming the age distribution of the employees is normal, and no unusual actuarial assumptions are necessary.[1] The real test of superior portfolio management is whether or not management meets objectives, and one of the prime objectives should be to reduce pension costs to the company, with due regard to risk and safety.

IMPACT OF PENSION COSTS ON CORPORATE EARNINGS

The above discussions have centered on the portfolios and performance of pension fund investment programs, and how these two aspects are affected by internal and external influences. Conversely, it is well to consider at this point just what influence they have on the corporation's financial operations.

A recent article in Forbes Magazine appraised the pension situation from the standpoint of the investor with the caption "Warning: These People Can Be Dangerous," which appeared under a photograph of retirees in rocking chairs. The article went on to say that the day may come when U. S. business is paying as much to pensioners as to stockholders, and pension obligations "may force some major U. S. corporations to the wall."[2]

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[1]Kopp, Managing Pension Portfolios, p. 18, and Metzger, Investment Performance, p. 344.

[2]Employee Benefit Plan Review, Forbes Looks at Pensions, November, 1970, p. 81.

The implications of the above statement are obvious. Pension contributions can come from only two sources, outside investments and internal operations. What outside investments do not provide in offsetting pension costs must be provided by cash flows within the corporation. These contributions, coming from corporate earnings can have only one effect on profits and earnings per share, they can only decrease them. Thus the need for superior investment performance by pension fund trustees.

A pension fund, as previously mentioned, can be an important profit center for a corporation as above average investment results have a direct bearing on profits through keeping costs down. In fact, the results of the pension fund investment program can be more important than the profit results of large divisions in some companies.[1] When the subject of profits is discussed, the responsibility of corporate management shifts from its employees to its shareholders. The objective of a company, as far as its owners are concerned, is the maximization of profits and value of the company in the market place. Common stock valuation is perhaps effected most by earnings per share of the company's stock, and these earnings are greatly influenced by pension costs.

Even though a company's contributions to its pension fund are tax deductible, they can have an especially serious effect on earnings during lean years, when corporate profits are already down and stock market conditions are normally

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[1]Bagnall, "Alternatives in Investment Management," 36.

poor, producing less return on investments. These situations create an even greater need for corporate funds to offset total pension costs.

Some examples of the effect of pension costs on earnings are: (1) in 1969, Western Electric Company contributed $128 million to its pension plan - more than half as much as that year's total profit, and (2) in 1970, American Airlines showed a loss of $1.30 per share, but it would have been a profit of .50 per share if the company had not been obligated to contribute $37 million to its pension fund to meet actuarial requirements.[1] Table 8 indicates the proportionate size of a random sampling of pension fund contributions of some major U. S. corporations for the year 1969. It is obvious that in each case the pension fund of the corporation is a major operation within the corporate structure of its organization, and more than likely is getting more than just token attention in its administration and management.[2]

The extent to which a company is able to meet its pension costs from annual contributions and return on assets alone is extremely important to the markets and the nation. During extremely adverse market and economic conditions, when both corporate profits and return on investments are both extremely low, the possibility exists of many companies being

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[1]Business Week, The Pressure on Pension Funds to Perform, 89.

[2]Stewart,"Splintering Pension Funds," 55.

TABLE 8

RANDOM SAMPLE OF PENSION CONTRIBUTIONS
VERSUS AFTER TAX EARNINGS

Company	1969 Earnings After Tax ($Million)	1969 Pension Contributions ($Million)	Percentage of Pension Contributions to Earnings
U.S. Steel	217	72.6	33.5
IBM	933	108.0	11.6
Texas Instruments	33	8.2	24.8
Standard Oil (N.J.)	1,243	48.6	3.9
Johnson & Johnson	58	6.2	10.7
Eastman Kodak	400	56.4	14.1
Cutler Hammer	6	3.2	53.3
Clark Equipment	38	8.4	22.1
Brunswick	14	3.0	21.4
Caterpillar Tractor	142	30.5	21.5

Source: Securities and Exchange Commission and Pension and Welfare News.

forced to liquidate large portions of their pension fund assets to meet current needs. This basic conversion of the private pension system from net accumulator of capital to net dissipator could have far-reaching and chaotic effects on the financial community. What may be even more detrimental is the case where pension liabilities are made binding by union contract or by legislation, in which instance the company may be compelled to even sell off corporate assets in order to meet claims.[1]

The possibility of all the above events occurring are admittedly rare. Usually pension obligations have no claim on corporate assets, and many large, well-managed companies can owe their pension funds certain amounts of money, waiting for conditions to improve before making additional contributions. This does not matter when the company is strong and durable, but it is hard on employees of companies that go broke or merge, and every year about 30,000 people lose out on pensions because their companies go out of business.[2] The aforementioned Studebaker affair was a prime mover toward stricter government regulation and reform to prevent this very thing from happening.

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[1]Gumperz, "Pension Funds in an Age of Discontinuity," 119.

[2]Burck, "That Ever Expanding Pension Balloon," 130.

CHAPTER V

OUTLOOK FOR THE FUTURE

ROLE OF THE GOVERNMENT

Very few people doubt the sincerity of the majority of present corporate management in their efforts to improve the pension fund system as it now exists, and, probably because these systems are wholly voluntary they have been subjected to relatively little regulation and control. Considering this lack of regulation, the fact that there have been so few cases of mismanagement or manipulation is quite surprising. Most of the funds are scrupulously managed by trustees who are highly dependable and ethical, but in some instances corporations have borrowed from their funds, or tried to control companies whose stock they own. Also, in a few banks and insurance companies that manage funds, decisions about investing the funds' assets are influenced by the interests of some other department.[1]

The recent United Mine Workers case is perhaps the most flagrant example of abuse of management responsibility. The U.M.W. fund was managed by so called "trustees" who employed friends and relatives of union officers. Also, it

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[1]Burck, "That Ever Expanding Pension Balloon," 103.

accumulated up to $78 million and kept this cash in non-interest bearing deposits in a bank which was controlled by the union as majority stockholder. The courts found the union and the "trustees" guilty of neglecting their obligation to the fund's beneficiaries by failing to develop a coherent investment policy.[1] The case is still the subject of much discussion in government circles.

Such are the reasons for the increased attention and concern on the part of legislators for increased government involvement and control in the nation's pension and welfare system. Recommendations for reform have varied from minor reform of the present system to a complete government take-over of pension responsibility and administration.

In the latter regard, many influential people in Washington, including members of Congress, have voiced their opinion that they believe that social security can perform the function of distributing pension benefits much better, more efficiently, and more equitably than privately managed funds. They argue that private pension plans do not cover all the workers, discriminate against low-paid and temporary workers, are wasteful, and exert the wrong economic pressures. They therefore argue that in order to achieve the true objective of a universal pension system the nation must integrate all the private plans into an expanded social security program.[2]

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[1]Ibid.

[2]Ibid., 100.

There have been many recommendations and bills presented by Congressmen to regulate the pension funds. The main provisions of the pending legislation concern the subjects of vesting, portability, minimum funding standards, and the establishment of a mandatory system of insurance of benefits in the event of involuntary plan termination. The latter two subjects are self-explanatory, but vesting and portability should be explained.

Vesting is the guarantee of pension benefits to an employee who has worked a specified number of years or reaches a certain age, even if no longer with the company. If a plan is fully vested after 15 years of service, a 20 year old worker could leave the job as early as age 35 and count on collecting his deferred pension credits from his old employer when he fully retired at age 65.

Portability would enable the employee to transfer his claims, whether vested or not, from one place of employment to another, no matter how frequently he may change employment during his lifetime. Without vesting or portability, a worker could conceivably work for three or four companies during his working life and still be entitled to no benefits except for social security. All these companies could have employee pension plans, but because of the lack of vesting and portability provisions, the worker would have suffered irreparable loss of pension benefits.

A recent House bill, submitted by Representative Dent of Pennsylvania, calls for strict standards of fiduciary responsibility, full vesting in 10 years, and the funding of past service

liabilities over twenty-five years in the case of companies who presently do not have a pension plan but will incorporate one. The bill also proposes to establish federally administrated insurance (sometimes called reinsurance), paid for by employers, against the loss of vested pension benefits when a company goes out of business or otherwise suddenly terminates its plan.[1]

A Senate measure, sponsored by Senator Jacob Javits of New York, differs from the Dent bill mainly in that it would vest 10 per cent of a participant's credits after six years of aggregate service and 10 per cent a year thereafter. Senator Javits also proposes voluntary portability for employees, and the setting up of a government commission which would administer all pension laws, thus superseding the Internal Revenue Service and the Labor Department.[2]

In addition to the above legislation, President Nixon himself has made proposals of his own. In addition to the tax deductions of up to $1500 contributed to an individual's own retirement fund, he has proposed raising the ceilings on annual tax deductions to 15 per cent of earned income or $7500, whichever is lower, in the cases of self-employed persons (Keogh Plan). With regard to the private pension plans, the President's measure would require 50 per cent vesting after age and years of service totaled 50, and another 10% would be added each year until the employee was fully vested.[3]

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[1]Ibid., 131.

[2]Ibid.

[3]United Business Service, United Opinion From Washington, December 27, 1971, p. 514.

The above proposals, both by the Congress and the President, are bound to meet with some objection from most businesses and even labor unions. The biggest defect of the reform bills, and a defect that is probably agreed upon by both labor and management, is that they would do nothing about the most important deficiency of private pensions: being voluntary. Private pensions now cover only about half of all employees in the private economy, and if private pensions are ever to fulfill a social role, they must be expanded to cover nearly all the working population.[1]

Most other opposition to the reforms has come from businesses that operate or administer private pension plans. The increased standards for fund management and disclosure would add relatively little to pension costs, but liberalized requirements on vesting, funding, portability, and reinsurance would be so expensive that they would possibly squeeze private pension plans out of business. The fear of management is that if this were to happen, the private pension plans would be replaced by a rambling, expensive, inefficient, Federal bureaucracy, probably under the Social Security System. Of course, business is also highly concerned over the possibility of Federal regulation of their now largely unregulated domain.[2]

Would turning over the private pension system to the government solve all the stated problems? Probably not. Social Security is now operated on a pay-as-you-go basis: it taxes

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[1]Burck, "That Ever Expanding Pension Balloon," 134.

[2]United Business Service, United Opinion From Washington, October 12, 1971, p. 404.

payrolls and distributes the money as pensions and other benefits. If pensions were to be raised, the social security tax rate would also have to be raised considerably, seriously affecting the spendable income of lower-paid workers. Also, if pension business were shifted to social security, these funds would be no more and would not be available in the marketplace. To the extent that the government chose to fund social security, it would invest in its own bonds, and business would have to raise even more of its capital internally than it does now, or might even have to turn to the government itself for capital.[1]

Despite all the objections and shortcomings of the proposed bills, nearly everyone concerned is resigned and reconciled to the idea that some sort of legislative action will be passed by Congress in the next few years. Mandatory vesting, stricter funding requirements and some sort of reinsurance look inevitable in a period of time in our history when pensions are looked upon more as a right than a privilege.

Legislation is almost certain to come in the area of disclosure by the funds. Present disclosure laws create only a mass of meaningless documents submitted to the Labor Department and the Securities and Exchange Commission. It is universally felt that sponsors should be required to tell participants exactly what benefits are due them, when they are due, what options are available to them, and the consequences to them in the event they decide to change jobs.

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[1]Burck, "That Ever Expanding Pension Balloon," 102.

Strict disclosure, not only to employees, but also to the government, will almost assuredly also be enacted. At present there is only minimal requirements for the companies to report and account for the vast sums of money in their pension funds. Congress is probably long overdue in providing some effective supervision of the pension funds that so many workers are dependent upon.

Labor is obviously pushing these reforms and businesses don't have much solid ground to stand on in their rebuttals. Their only hope is that Congress will not attempt to transform the whole system overnight and not to make requirements so strict that the pension funds may be wiped out rather than strengthened.[1]

WHAT LIES AHEAD

Pension funds have made great gains in the past 20 years, with not only assets increasing markedly, but benefits paid to retirees also having greatly expanded. With inflation, union demands, government concern, and individual employee requests all continually increasing, it is by no means conceivable that this tremendous past rate of growth will lesson to any extent.

There have been many estimates made as to how many workers will be covered, what benefits will be, and what total pension fund assets will be 10 or 15 years hence, but all these

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[1]Business Week, Tighter Rules For Pensions, Editorial, September 11, 1971, 138.

items depend greatly on which avenue of reform the government decides to take in its efforts toward new legislation concerning private pension funds. That the mentioned categories will increase is beyond doubt, the ultimate question is how much? Average estimates of the size of pension funds in the year 1980 are total assets of approximately $225-$250 billion, with annual payout of $9 billion to approximately 6.6 million annuitants. These figures compare with $125 billion, $6 billion, and 4.2 million pensioners respectively in 1970.[1]

It is not unlikely that future retirement income objectives will be in range of 75%-100% of final average wage or salary, compared to about 40% today. This goal reflects society's continuing emphasis to guaranteeing that living standards attained by an individual during his working life be, by and large, maintained during his years of retirement. Retirement income, in this sense, is the combination of pension and social security payments. So, as social security benefits are enlarged, the less the private pension plan will have to pay, assuming there will be some tie-in of pension plans to social security. This does not offer much hope for corporate pension costs because social security contributions, by employer and employee, are already fast approaching the limits of tolerability, and prospects of greatly increased social security benefits are not too promising at the present time.

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[1]Employee Benefit Plan Review, Professors Dote on Establishing Criteria, But Practitioners Somewhat Less Enthusiastic, February, 1968, p. 8, and Business Week, Pressure on Pension Funds to Perform, 88.

With these factors in mind, the burden falls on the private pension system to come upon desirable directions in which to move in order to prevent a collapse of the entire system. Primary among all future considerations is that pension funds are very important to all concerned and that long-range strategic planning will have to become standard procedure instead of haphazard and short term. The possible options which are generally considered available to assist in the funding of private pension plans are listed below, but as will be seen, they all have limitations or disadvantages, to either the employee or to management.

1. Variable Annuities. Under this option, between one-third and one-half of pension benefits would be allowed to vary with returns on fund assets. This is not desirable for the workers because most workers would rather have definite benefits which can be counted on, and would permit variability of benefits if they varied in only one direction - up.

2. Increased Employer Contributions. Since most companies already are suffering from a profit squeeze, increased contributions by the employer might even turn profits into deficits, which would result in a lowering of economic activity.

3. Increased Employee Contributions. Labor unions obviously oppose this since they insist that providing retirement benefits is the sole obligation of employers. However, there may be some increase in this area if the

employee contributions can be made tax-deductible, as proposed recently by the President.

4. Pension Insurance. This can take the form either of (1) having the insurance company assume responsibility for paying specified benefits in return for the premiums paid by the employer or, (2) reinsuring the fund the employer himself accumulates. Either system would be acceptable, except that regular premium costs for the employer would be extremely costly, much more so than the costs involved for the same benefits that self-funding would require.

5. Aggressive Investment Policies. Since the above four options are all with their own limitations, pension fund trustees have eagerly turned to this option as a means of offsetting increased costs. The advantages, disadvantages, and possibilities of this approach have been discussed in this paper, but it also is not without its own limitations.

The problems, possible solutions, implications, and consequences of an adequate or inadequate pension system in this country have been brought to the surface, concentrating on the corporate pension system. Where the government, management, and labor proceed from here only time will tell, but it is hoped that all parties concerned start moving in what is hoped to be the right direction, not only soon, but cautiously and rationally. The well being of our older citizens and the enhancement of free enterprise depend on it.

CHAPTER VI

SUMMARY AND CONCLUSIONS

The realization of the need for a pension system for the nation's workers did not develop until late in the nineteenth century, and for over 50 years after the establishment of the first plan, progress was indeed slow. The fact that industry, the railroads, and labor unions devised their own plans long before the federal government's Social Security Act in 1935 perhaps explains this slow growth of private or public pension plans. Since that time, public and private plans have grown tremendously, with both costs and benefits expanding at an extremely fast pace every year.

Historically, as far as the corporate pension plan is concerned, the company owners (employers) have borne the cost of all pension fund programs, and generally speaking, this should be the case in the future. However, with the costs of pension programs taking a greater percentage of corporate earnings than ever before, the prospect of substantial contributions from the employees themselves is increasing. The demand for increased benefits after retirement, plus the government's acknowledgement of the substantial costs to the employer by its recommended tax relief for all contributions to pension funds, should pave the way for increased

participation by pensioners, despite the lack of support for contributory plans by the labor unions.

In establishing the framework for corporate pension plans, the administrators and managers of these funds must consider many facets before deciding what the actual long term objectives and policies are going to be. It is imperative that the conflicting interests of the pensioners and shareholders be balanced as well as possible, hopefully to the approval of both groups. Various constraints, implications, trends, and possible consequences all have to be delved into at great length before the selection of investment advisors and investment performance criteria is undertaken.

The increasing importance of pension fund assets, not only to the employer, but to the employee as well, has brought about a shift in the original thinking as to the proper place for the pension program in the corporate structure. It has become apparent that the pension program is as much a user of capital as any other division of the company, and thus can contribute it's share of profits (or losses). This has resulted in more attention being devoted to these assets, with the investment policies shifting from the conservative end of the continuum to the more aggressive, highly diversified end, as far as investment portfolios are concerned.

Corporate pension fund assets at present constitute the largest aggregation of private capital in the United States, and with the changing trustee emphasis toward performance, these funds will have greater and greater influence on stock

market movements as the trend toward equity investment continues. Not only is the cost factor of pension funds instrumental in the shift to common equities for greater possible return, but the employee retention aspect is equally as important. Today's changing society has become extremely welfare-oriented and employees are not only requesting higher benefits, but demanding them, and threatening change of jobs if the pension plan of a firm is not adequate. A pension plan that adequately provides the benefits demanded by employees and labor unions is extremely costly, almost forcing the company to seek ever-higher returns on investments.

A firm can pursue these high returns in many ways, but the definite trend has been toward common stocks and capital gains. Despite this more aggressive investment posture, the average private pension plan's investment performance has not performed as well as most stock indices, and certainly not as well as might be expected. This may be expected to change as the pension trusts become able to liquidate low yielding investments that are not matured yet and have locked in funds for many years. Nevertheless, trustees for these funds will continue to be under great pressure to increase total rates of return in order to reduce not only pension costs, but their impact on earnings as well.

The occurrence of a few unethical and improper practices, along with some corporate business failures, has prompted the federal government and individual legislators to propose drastic

reforms for private pension programs. Stricter rules on disclosure of pension information by employers, provisions for vesting and portability of pension benefits, reinsurance of benefits, and other reforms all will increase pension costs considerably and may even force the corporate pension plans out of existence. The prospect of a completely government-controlled pension program for all citizens is not outside the realm of possibility, but is considered to be highly detrimental to the country's financial markets as well as to the free enterprise system.

It will take the efforts of all concerned to correct the present ills of the private pension program and to improve the system for future retirees. The federal government must propose reforms, but must also be careful not to force too many obligations on the companies all at once. The major burden falls on corporate management. Business will have to improve efficiency, select capable fund managers and provide the financial planning and investment criteria necessary to make pension assets truly productive capital. Employees and labor unions will be compelled not only to temper their wage and pension demands, but to also do their utmost to increase the over-all productivity of the nation's industrial capacity.

Only with all these groups working toward the same goals will the nation's private pension system become not only adequate, but equitable as well.

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